MACRO INTELLIGENCE 2 PARTNERS

MI2 Trader: Growth Swan Dive

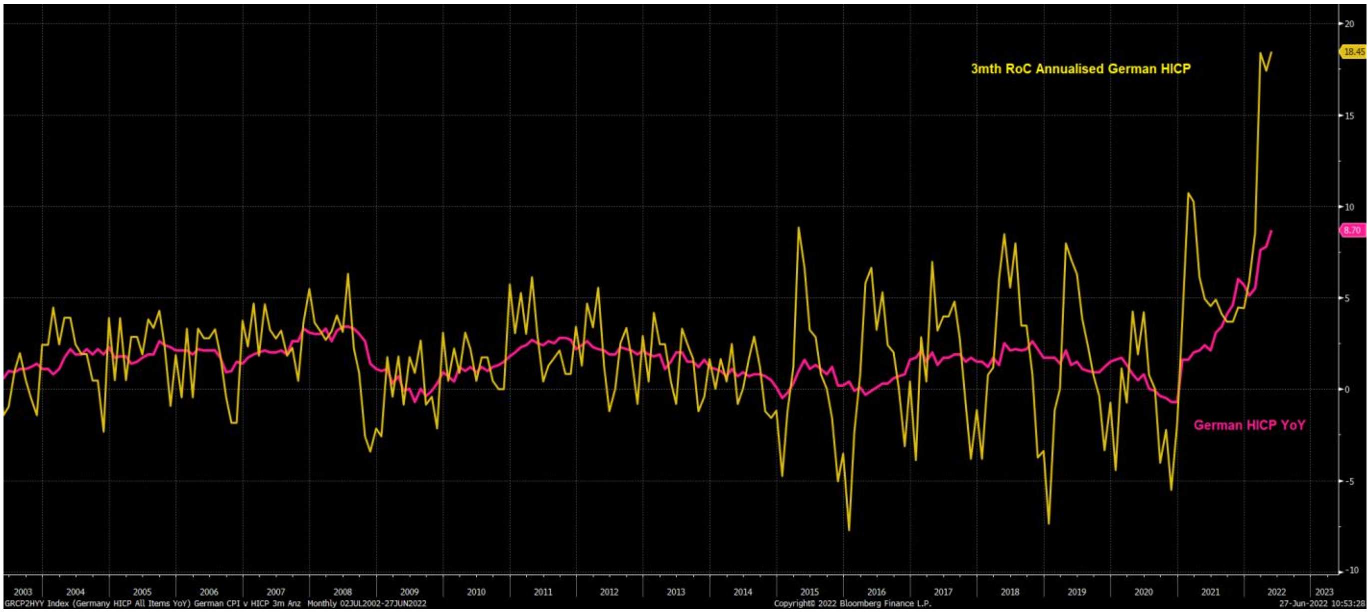
28th June 2022

Comment

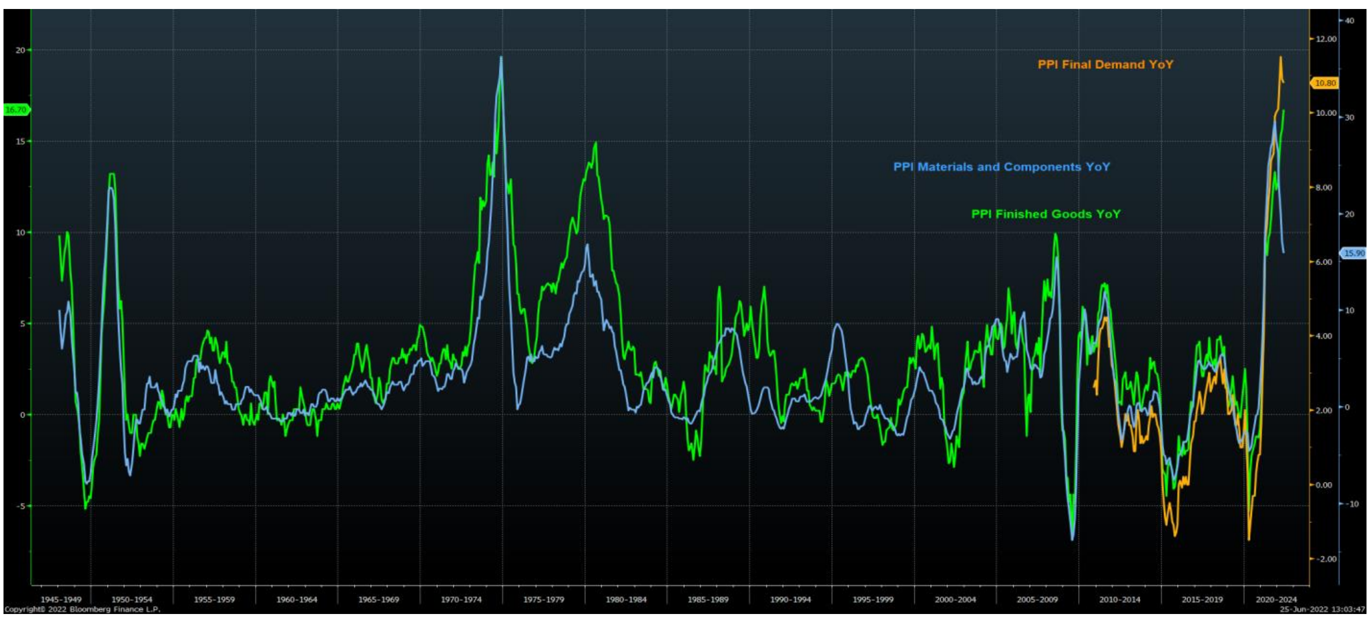
At the end of last year, we outlined that while the resurgence of inflation had characterised 2021, 2022 would mark the beginning of a return to boom/bust economics and extreme market cyclicality ("2022: Accelerative Oscillations" 14th Dec. 2021). Behind this thesis was a belief that deglobalisation would be accompanied by a return to violent inventory swings and the end of the "Great Moderation". In addition, as in the late 1960s, inflation would catch policymakers napping and force them into chasing the cycle. The result would be the end of gentle, proactive monetary adjustments, which dampened the amplitude of the economic cycle, and a shift to a reactive and often mistimed application of policy that could quickly reinforce market and economic volatility. In some ways, this is the central bank equivalent of trading negative gamma. Add in hyper-financialisation, and you have the perfect conditions for policy error. We always knew that such an environment would be extremely tough to trade because economic conditions could flip between inflation and growth on a dime. Fast forward six months, and with Jay Powell intent on restoring price stability, the stage is set. Add in a faltering stock market, which is already driving CEOs to reach for their cost-cutting axes and the material implosion in the PMIs of the last two weeks, and we believe that we stand on the cusp of our first growth swoon of the post-Covid era ("US Recession: Chicken or Egg" 8th June). Hence, today, we want to share with you some key data points we are watching and some possible trading opportunities.

We'd like to tell you that with growth faltering, inflation will melt away because it would make trading infinitely easier. After all, that has been the pattern for the last 40 years. Unfortunately, except for the UK, the picture isn't that clear yet ("MI2 Trader: Buy Sonia SFIZ3" 23rd June). We are particularly apprehensive about the Eurozone, where the next round of inflation data starts on

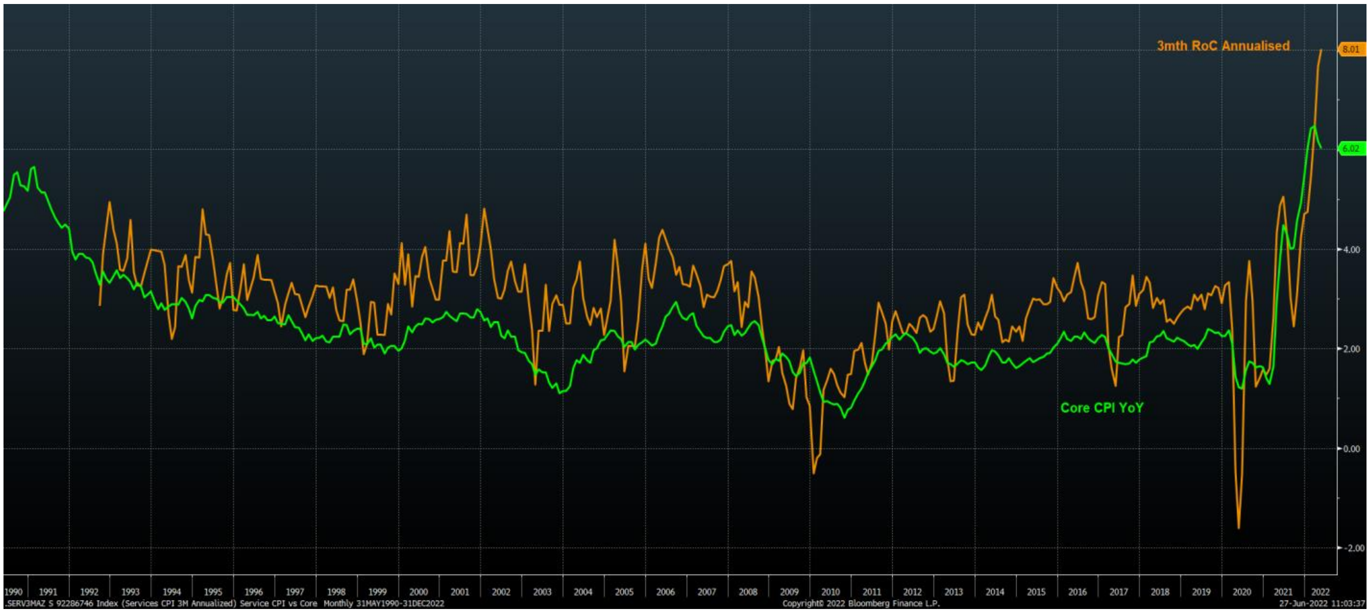
Wednesday. Take Germany, for example; while headline HICP is running at 8.7% and is expected to rise to 8.8% this week, the three-month annualised rate is already just shy of 18.5%, which suggests we could be in for yet another shock ("Growth Is Slowing. But Are We There Yet?" 19th June).



The picture looks a little more encouraging in the US, but it is hard to be conclusive. The most we can say is that there are some signs that PPI pressures, especially of "material and components", might have peaked.



Unfortunately, if we look at the rate of acceleration in service inflation, it continues to suggest that we need to be braced for continued high inflation prints, with a peak in overall inflation a few more months away.



This mixed message is visible in the latest comments from the S&P US Composite Index, released last week.

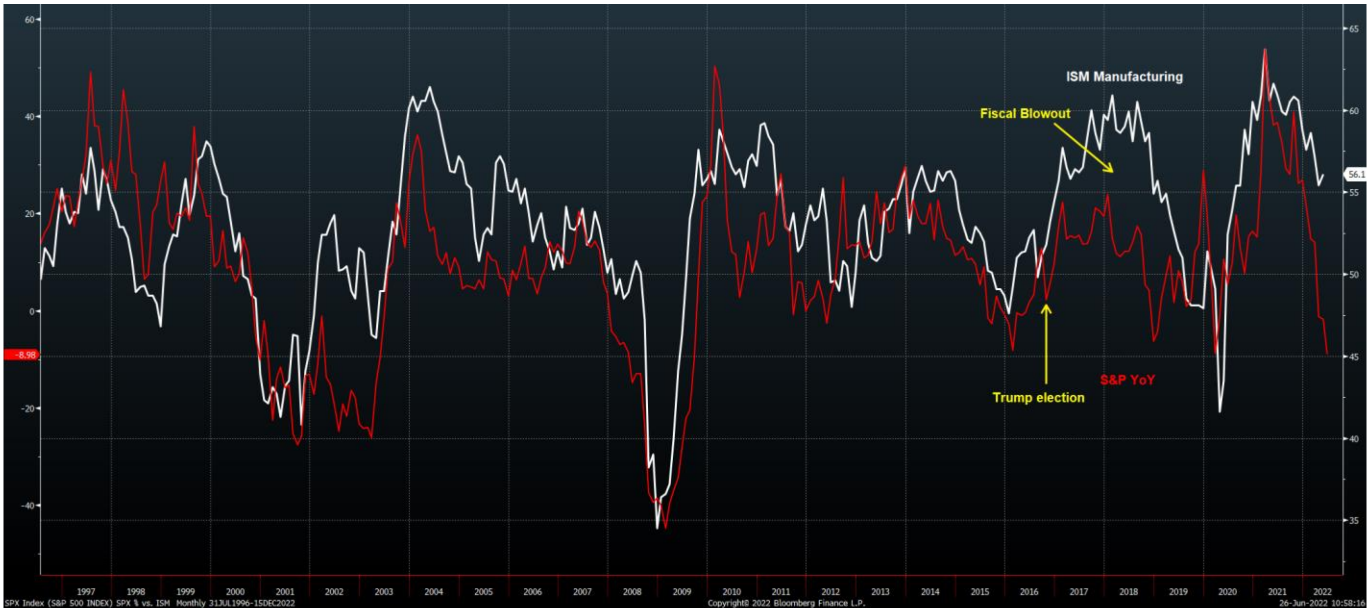
> *"Average cost burdens continued to rise substantially and at a historically elevated pace in June. Hikes in vendor, material and fuel prices all spurred on inflation. Nonetheless, the rise in input prices was the slowest since April 2021. At the same time, efforts to entice customers to make purchases led to the softest rise in output charges since January. The rate of change of inflation was faster than in any period before May 2021, however".*

So the "good news" is that while input prices remain elevated, they might be plateauing. The "bad news" is that companies are having to "entice" customers, which suggests that all of a sudden, we might have an aggregate demand problem. A risk underlined in comments from S&P's Chief Economist.

> *"Having enjoyed a mini-boom from consumers returning after the relaxation of pandemic restrictions, many services firms are now seeing households increasingly struggle with the rising cost of living, with producers of non-essential goods seeing a similar drop in orders."*

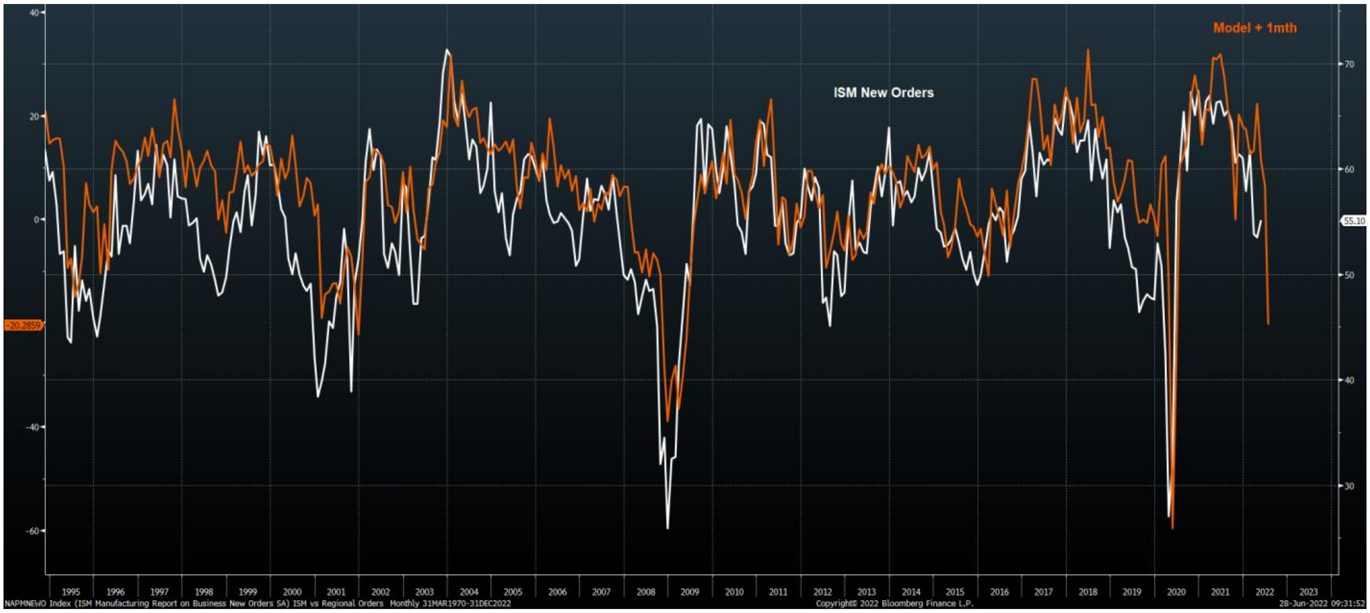
> *"There has consequently been a remarkable drop in demand for goods and services during June compared to prior months".*

As we said in the introduction a couple of weeks ago, when we parsed the PMIs, there were no signs of weakness, let alone anything "remarkable". So what's going on? Why such a dramatic pivot? The obvious explanation is financialisation, whereby equity weakness is already weighting on business sentiment ("US Recession: Chicken or Egg" 8th June).



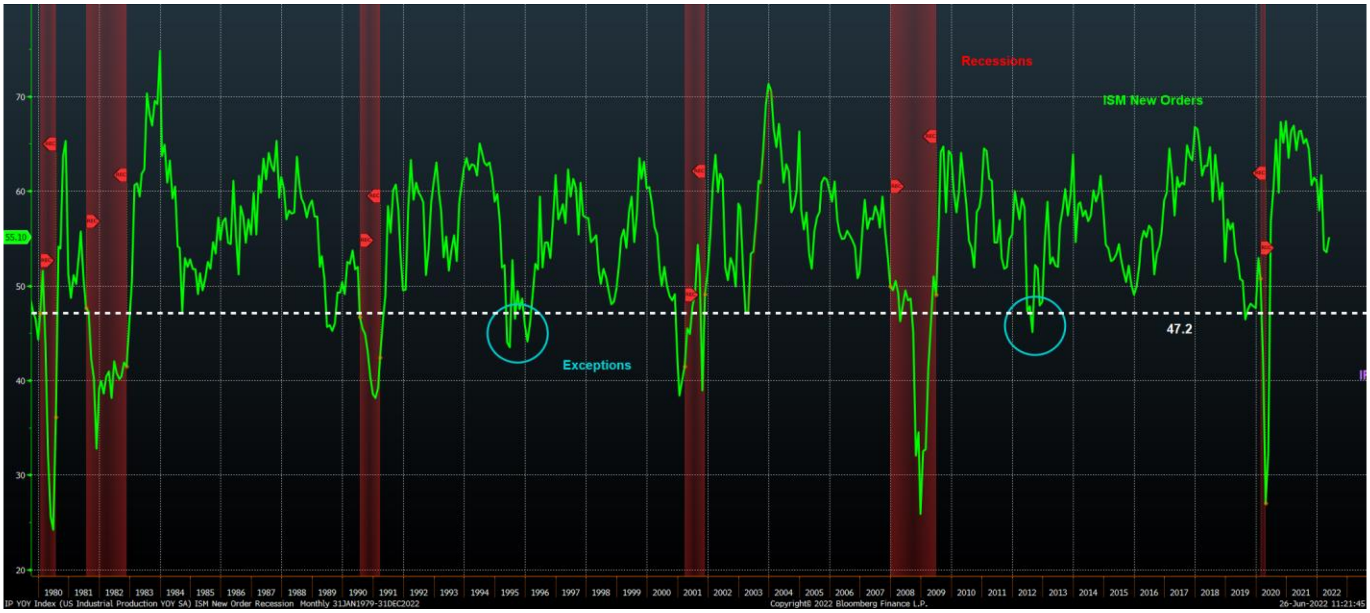
If we focus on this Friday's ISM Manufacturing Survey, we are looking at an utter swan dive sub-50, which would blow away the market's expectations of 54.7.

The same is true of New Orders, which last month were 55.1 but look to be heading towards 45.



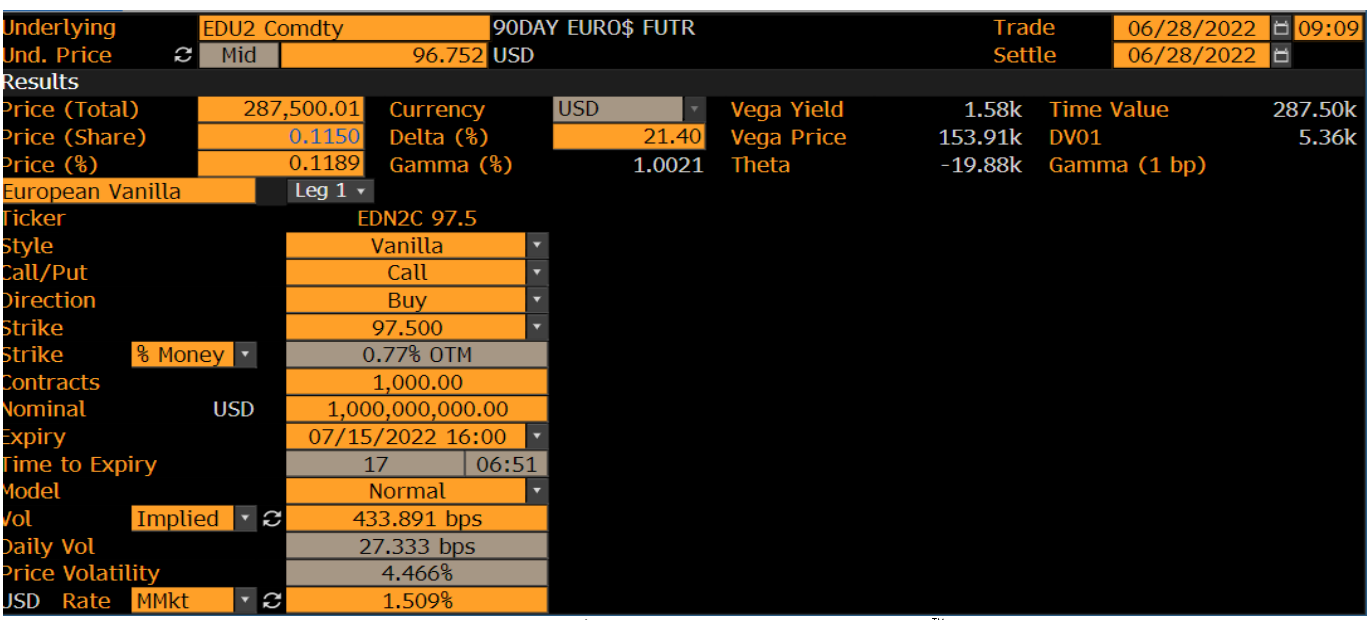
Another highly financialised metric that you should have on your radar is JOLTS. The next release is on the 6th of July and is significant because of Powell's focus on reducing the demand for labour. Bloomberg hasn't yet posted a forecast. But if the correlation to the S&P holds, then we should expect a big drop from the current 11.4mio.

What does it all mean for markets? First, don't forget that the Fed wants to see growth slow, and with their SEP 0.5 rise in unemployment, they are, in essence, already forecasting a recession. So this is all part of the plan. However, even if the Fed continues to hang tough and frontloads as many hikes as possible, if we are right about data declines of this magnitude, Powell's assurances that the economy is "very strong" and "can withstand rate hikes" are entirely misplaced. That suggests that we could be approaching an inflexion point in markets as they start to discount current inflation levels as unstainable in an environment of rapidly faltering growth. P.S. historically, ISM Manufacturing New Orders sub 47.2 are associated with a recession.



Trades

The backdrop suggests a possible shift in the tightening of financial conditions, from rates to stocks and credit. This should help our Eurodollar trade as the market moves to price in a lower terminal rate ("MI2 Trader: Buy EDZ3" 23rd June). Indeed, on a specific play on ISM and JOLTS, we would suggest buying 20 delta calls approx. 97.50 on EDU2 expiring on the 15th July (EDN2C).



Underlying	EDU2 Comdty	90DAY EURO$ FUTR		Trade	06/28/2022	09:09	
Und. Price	Mid	96.752	USD	Settle	06/28/2022		
Results							
Price (Total)	287,500.01	Currency	USD	Vega Yield	1.58k	Time Value	287.50k
Price (Share)	0.1150	Delta (%)	21.40	Vega Price	153.91k	DV01	5.36k
Price (%)	0.1189	Gamma (%)	1.0021	Theta	-19.88k	Gamma (1 bp)	

European Vanilla		Leg 1
Ticker		EDN2C 97.5
Style		Vanilla
Call/Put		Call
Direction		Buy
Strike		97.500
Strike	% Money	0.77% OTM
Contracts		1,000.00
Nominal	USD	1,000,000,000.00
Expiry		07/15/2022 16:00
Time to Expiry		17 06:51
Model		Normal
Vol	Implied	433.891 bps
Daily Vol		27.333 bps
Price Volatility		4.466%
USD Rate	MMkt	1.509%

The only potential fly in the ointment is the reaction of credit and stocks to weak economic data that drag yields lower. If they see the move in bonds as an excuse to rally, the Fed will have to continue to tough it out, and ultimately even our cautious stab at a long rates trade will struggle. However, that shouldn't be the case because credit is usually highly correlated to PMIs. A drop in the ISM Manufacturing headline rate to sub-50 should push CCC vs B credit spreads out about 200bps, a 50% move.

Equities also shouldn't take a rapid deceleration in growth well because any benefit of lower rates should be offset by a significant reduction in earnings expectations, which typically fall 40% in a recession. We say "should" because thus far, analysts continue to expect higher earnings growth in 2023!!!! Perhaps a shift in the data will force them finally to embrace reality! But what is certain is that if we get a weak ISM Manufacturing on Friday, the price action of stocks will be a real tell.